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No. 84-1737

In the Supreme Court of the United States

OCTOBER TERM, 1984

UNITED STATES OF AMERICA, PETITIONER

v.

AMERICAN COLLEGE OF PHYSICIANS

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

REPLY BRIEF FOR THE UNITED STATES

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The thrust of respondent's brief is that the court of appeals decided this case "on a narrow factual basis" (Br. in Opp. 10). Respondent accordingly disputes our contentions as to the decision's administrative importance and revenue impact (*id.* at 15-18).

1. The ultimate question in most cases involving the unrelated business income tax is whether the business is "substantially related" to accomplishment of the organization's tax-exempt purposes (I.R.C. § 513(a)). The answer to this question will ultimately depend "upon the facts and circumstances involved" (Treas. Reg. § 1.513-1(d)(2)). In reaching an answer, however, the trier of fact must be guided by proper legal standards. We argued to the Claims Court that the legal standard relevant here is set forth in Example 7 to Treas. Reg. § 1.513-1(d)(4)(iv), which Congress explicitly approved in 1969 and determined to "place[ ]

in the tax laws" (S. Rep. 91-552, 91st Cong., 1st Sess. 75 (1969)). Example 7 concludes that a tax-exempt professional association's publication, in its scholarly journal, of advertising "designed and selected in the manner of ordinary commercial advertising is not an educational activity"; that publication of such advertising "does not contribute importantly to the accomplishment of [the organization's] exempt purposes"; and that the income from such advertising "constitutes gross income from unrelated trade or business." Under this legal standard, we argued, it was incumbent on respondent to show that its advertising differs from that described in Example 7, *i.e.*, to show that its advertising is not "designed and selected in the manner of ordinary commercial advertising."

The Claims Court accepted our legal argument. It noted that the "Treasury Regulations provide that advertising income of journals like *Annals* generally is taxable," and it ruled that "Example 7 * * * closely resembles the situation here" (Pet. App. 29a). The court then held that respondent had failed to prove that its advertising differed from that described in the Regulation. The advertising in *Annals*, the court found, "was typical commercial publicity," and respondent's advertising business "was operated in material respects like the advertising business of any other publication" (Pet. App. 28a, 33a).[1]

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[1]Respondent contends (Br. in Opp. 7, 11 & n.17) that, under the legal theory advanced in our petition, a trial would have been unnecessary in this case, and hence that our position represents a change from the position we took in the Claims Court, where we did not seek summary judgment. This contention is incorrect. We contended below that Example 7 sets forth the controlling legal standard; we agreed, however, that respondent was entitled to prove that its advertising differs from the advertising described in that Example. The Claims Court held a trial for that purpose, and, as noted in the text, concluded that respondent had failed to carry its burden of proof.

On appeal, respondent contended that the Claims Court had "mistakenly concentrated upon [the commercial] aspects" of its advertisements and in so doing had "applied the wrong legal standard" (C.A. Br. 8). While appearing to concede the validity of the Regulation (*id.* at 33), respondent argued that Example 7 should be interpreted as applying only to advertising published by organizations exempt from tax under Section 501(c)(6), and not to advertising published by organizations (like itself) exempt under Section 501(c)(3) (C.A. Br. 30-31). Respondent concluded that "[t]he standard which the lower court applied * * * goes far beyond statutory and administrative language and intent, and constitutes a clear error of law requiring reversal in this case" (*id.* at 27, 33-34).

The Federal Circuit agreed with respondent that the Claims Court had "erred in requiring [its advertising] activity to meet a standard higher than set out in the statute" (Pet. App. 17a). The court brushed aside the legislative history upon which we relied, asserting that it "addresses advertising generally and does not grapple with specific factual situations" (*id.* at 13a). The court did not even mention the Regulation we contended was controlling. And it held that the trial judge, in relying on "the similarity [of respondent's advertising] to the content and conduct of advertising in commercial publications," had incorrectly evaluated respondent's ads under "a more rigorous standard than is supported by the statute" (*id.* at 16a).[2]

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[2]As emphasized by respondent (Br. in Opp. 9, 11) and by amicus American Society of Association Executives (Br. 3, 6), the court of appeals ruled that the trial court's ultimate finding — that respondent's advertising was not "substantially related" to its exempt educational purposes — was "clearly erroneous" (Pet. App. 19a). The Federal Circuit, however, accepted all the Claims Court's findings of basic or subsidiary fact; it reversed because (as the quotations in the text show) it believed that the Claims Court had evaluated those facts under an incorrect legal standard.

As this review shows, the issues presented by this case are not "factual." We contend that Section 513(c), its legislative history, and the Treasury Regulation Congress explicitly approved in 1969 establish that revenues from advertising "designed and selected in the manner of ordinary commercial advertising" are subject to unrelated business income tax (Treas. Reg. § 1.513-1(d)(4)(iv)(Example 7)). Respondent contends that the Regulation does not apply to it (Br. in Opp. 11-13), and that the legislative history, read as we would read it, "cannot be squared" with the governing statute (*id.* at 14 & n.20). The questions presented, in short, concern the correct interpretation of the statute and the Regulation in light of the pertinent legislative history. These questions are obviously "legal" questions. Indeed, since respondent (as discussed below) concedes the validity of the Regulation, and hence concedes that its advertising revenues would be taxable if it were organized under Section 501(c)(6) rather than under Section 501(c)(3), the only question is the proper scope of Example 7, and the case thus presents no factual issue at all.

2. a. On the merits, respondent's attempt to posit a dichotomy in the treatment of advertising income, depending on whether the organization that publishes the advertisements is exempt under Section 501(c)(3) or Section 501(c)(6), is both unprecedented and wrong. Section 501(c)(3) provides a tax exemption for entities "organized and operated exclusively for * * * educational [and other specified] purposes." Section 501(c)(6) provides an exemption inter alia for "[b]usiness leagues." In order to qualify for exemption under the latter Section, an organization's activities must be "directed to the improvement of business conditions of one or more lines of business." Treas. Reg. § 1.501(c)(6)-1. See *National Muffler Dealers Ass'n* v. *United States*, 440 U.S. 472 (1979). Providing educational services to members on subjects germane to their professional

interests is among the purposes that may qualify an association for exemption as a "business league." *E.g., National Leather & Shoe Finders Ass'n* v. *Commissioner*, 9 T.C. 121 (1947). See generally *Louisiana Credit Union League* v. *United States*, 693 F.2d 525, 535-536 (5th Cir. 1982).

A professional association like respondent, whose members are drawn from a single profession and which has broad educational or charitable goals, generally has the option of qualifying for tax exemption *either* as an educational association under Section 501(c)(3) *or* as a business league under Section 501(c)(6). The chief differences are pragmatic. Section 501(c)(3) groups may receive donations that are deductible by individual donors as charitable contributions, whereas business leagues may not. See I.R.C. § 170(c)(2). Section 501(c)(3) groups, on the other hand, may not engage in political campaign activity or in substantial lobbying without forfeiting their tax exemption, while business leagues do not operate under those constraints. Compare I.R.C. § 501(c)(3) with I.R.C. § 501(c)(6). Thus, the form of tax exemption chosen by a professional association like respondent will typically depend on funding considerations and on the intended scope of its activities. Respondent and the American Psychiatric Association, for example, both of which publish scholarly medical journals for their members, are tax-exempt under Section 501(c)(3). The American Medical Association and the American Dental Association, which likewise publish scholarly medical journals for their members, are exempt under Section 501(c)(6).

b. Respondent notes that the organization described in Example 7 is "an association exempt under Section 501(c)(6), formed to advance the interests of a particular profession and drawing its membership from the members of that profession." Treas. Reg. § 1.513-1(d)(4)(iv) (Examples 6 & 7). Respondent expressly waives any challenge to

the validity of this Regulation (Br. in Opp. 12), and concedes that "the IRS may plausibly contend that Example 7 is a shorthand determination that advertising will not have a 'substantial relationship' to an exempt purpose for a [Section 501](c)(6) organization" (*ibid.*). Respondent contends, however, that "[t]he same cannot be said" for a charitable or educational group described in Section 501(c)(3) (Br. in Opp. 12).

The distinction respondent seeks to draw is utterly unprecedented. In the long, detailed history of this issue, we know of no instance (and respondent cites none) in which Congress, a court, or a commentator has suggested that the principles of Example 7 are confined to advertising published by Section 501(c)(6) organizations, to the exclusion of advertising published by other tax-exempt groups.[3] Spokesmen for numerous Section 501(c)(6) organizations (such as the American Medical Association, the American Dental Association, and the American Physical Therapy Association) and for numerous Section 501(c)(3) organizations (such as the American Psychiatric Association, the American Osteopathic Association, and respondent) testified before Congress in 1969. These spokesmen analyzed Example 7 in detail; at no point did they suggest that the taxability of advertising revenues from their medical journals would depend on the particular subsection of Section 501(c) under which they happened to be organized. Congress recited that the Regulation it aimed to codify had

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[3]Neither court below accepted, or even mentioned, respondent's suggested distinction. Commentators who have considered respondent's argument since the decision below was issued agree that the attempted distinction is meritless. See Weinberg & Nixon, *What are the implications of the Federal Circuit's holding in American College*? 62 J. Tax. 242, 243 (1985) ("[I]t may be that the court [of appeals] viewed Example 7 as inapplicable to a 501(c)(3) organization, but nothing in Example 7 suggests [that] such a restrictive application was intended by the Treasury.").

"mainly affected the advertising income of publications such as medical journals" (H.R. Rep. 91-413, 91st Cong., 1st Sess. Pt. 1, at 44 (1969)), and stated that, under the statutory standard it was then adopting, "advertising in a journal published by an exempt organization is not related to the organization's exempt functions" (*id.* at 50). Congress drew no distinction on that score between different species of tax-exempt groups that publish professional journals containing advertising.

Respondent's suggested distinction, moreover, makes no sense as a construction of the Regulation. While it is true that there are some "differences in purposes" (Br. in Opp. 12) between Section 501(c)(3) groups and Section 501(c)(6) groups, those differences, in the case of professional associations like respondent, are usually slight (see page 5, *supra*), and in any event are irrelevant in this context. A tax-exempt publisher of a professional journal, whether it claims exemption under Section 501(c)(3) or Section 501(c)(6), clearly has *educational* purposes. Indeed, Example 7 recites that "continuing education of its members in matters pertaining to their profession" is one of the purposes for which the business league described in that Example is granted exemption. It is the educational character vel non of the *advertising* that determines whether the resulting revenues are subject to unrelated business income tax. Example 7 squarely holds that "the publication of advertising designed and selected in the manner of ordinary commercial advertising is not an educational activity of the kind contemplated by the exemption statute" (*ibid.*). It can scarcely be contended that such advertising would become more "educational" simply by virtue of being published by an organization claiming exemption under Section 501(c)(3). Either the advertising is "educational" or it is not.

Respondent's suggested distinction, finally, makes nonsense of the policy of the unrelated business income tax. Congress enacted that tax, and amended it in 1969 specifically to bring advertising revenues within its scope, in order to prevent tax-exempt groups from obtaining an unfair advantage over their taxable competitors in the marketplace. On respondent's theory, revenues from a drug advertisement run in the journal of the American Medical Association, a Section 501(c)(6) group, would be subject to tax, while revenues from an identical drug advertisement run in its own journal would be exempt from tax, simply because it chose to be organized under Section 501(c)(3). The provenance of respondent's tax exemption, however, makes no difference to the taxpaying publishers with which it competes, and respondent's theory would perpetuate the unfair competition that Congress in 1969 aimed to stop. Indeed, respondent's theory would exacerbate the problem, for it would enable some tax-exempt publishers to compete unfairly, not only with taxpaying publishers, but with other tax-exempt publishers as well.

In sum, there is no merit to respondent's argument that the principles of Example 7 do not apply to it. It will not do for respondent to posit an erroneous distinction, suggest that the court of appeals, by its silence, "obviously agreed" with it (Br. in Opp. 13), and thereby excuse that court for ignoring a Regulation that Congress explicitly approved and that precisely describes the situation here.[4]

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[4]Contrary to respondent's contention (Br. in Opp. 6, 12, 14 n.20), Example 5 of the Regulation provides no support for its position. As we noted in our petition (at 19 & n.10), Example 5 concerns advertising published in a student-run campus newspaper, where "solicitation, sale, and publication of the advertising are conducted by students, under the supervision and instruction of the university" (Treas. Reg. § 1.513-1(d)(4)(iv)(Example 5)). The Example concludes that "the advertising business contributes importantly to the university's educational program through the training of the students involved" (*ibid.*). Noting that

3. Respondent's contention that this case lacks importance, on the theory that only "a handful of organizations exempt from tax pursuant to Section 501(c)(3)" will benefit from the decision below (Br. in Opp. 10), similarly lacks merit. That contention rests on respondent's argument that Section 501(c)(3) publishers and Section 501(c)(6) publishers are differently situated for purposes of the unrelated business income tax on journal advertising income. As we have pointed out, that attempted distinction is erroneous. Indeed, the tax-exempt press, far from suggesting that the decision below has "a narrow factual basis" (Br. in Opp. 10), has hailed it as "undoubtedly a landmark decision" that may enable "many non-profit associations * * * to establish that their journal advertising is substantially related to exempt purposes and not subject to taxation." 22 *Non-Profit Organization Tax Letter* No. 13, Oct. 5, 1984, at 3.[5]

Example 5 involves a university, a Section 501(c)(3) organization, respondent regards Example 5 as standing for the proposition that advertising published by Section 501(c)(3) groups is more likely (compared to advertising published by Section 501(c)(6) groups) to be "substantially related" to educational purposes (Br. in Opp. 12, 14 n.20). This suggestion is meritless. Example 4, the immediately preceding Example, also involves a Section 501(c)(3) group, one organized to advance "public interest in classical music," which owns a radio station; Example 4 concludes that the station's revenues "from the regular sale of advertising time to commercial advertisers in the manner of an ordinary commercial station" are taxable as unrelated business income. Treas. Reg. § 1.513-1(d)(4)(iv)(Example 4). Obviously, in these Examples, it is the similarity vel non of the advertising to *commercial* advertising, not the subsection of Section 501(c) under which the publisher is organized, that dictates the tax outcome.

[5]The newsletter also reminded tax-exempt groups that the decision below, unless reversed by this Court, "will become the governing law in the United States Claims Court which is a national court in which any organization may seek review of adverse determinations of the Internal Revenue Service." 22 *Non-Profit Organization Tax Letter* No. 13, Oct. 5, 1984, at 3. The newsletter suggested that, "[a]s long as this case stands, many associations should file their [tax returns] for 1984 showing no income tax on the advertising and refunds should be claimed for prior years." 22 *Non-Profit Organization Tax Letter* No. 14, Oct. 19, 1984, at 4.

Nor is there merit to respondent's argument (Br. in Opp. 15) that the nature of its advertising — being aimed at doctors — gives it a unique claim to exemption from the unrelated business income tax. After all, Congress said in 1969 that the Regulation it intended to codify "mainly affected the advertising income of publications such as medical journals" (H.R. Rep. 91-413, *supra*, at 44). The Claims Court found that respondent's advertising "was typical commercial publicity" (Pet. App. 28a), and respondent acknowledges that its ads are often identical to those appearing in medical journals published by taxpaying companies (Br. in Opp. 4-5 n.6). Indeed, amicus American Business Press advises (Br. 4-5) that one recent ad from *Annals* was carried in 25 other publications. The fine print in respondent's ads (see Br. in Opp. 3-4 & n.5) surely does not distinguish it from other publishers of medical journals, for that fine print typically reflects restrictions imposed by the FDA on the content of drug advertisements — restrictions that apply, of course, to all prescription drug advertisements across the board.

The effect of the decision below will be felt, moreover, in many areas besides medicine. Respondent has not advanced (and we cannot imagine) any reason why architects, chemical engineers, or water pollution experts would be less able than doctors to maintain that their professional goals are fostered by information contained in advertisements that "alert" them to developments in their respective fields. The reasoning of the decision below can be pressed into service by hundreds of tax-exempt professional and trade journals nationwide.

4. As noted in our petition (at 25-26), the decision below is the first by a court of appeals to consider the question presented here. Because the Claims Court is a court of nationwide jurisdiction, however, and because the tax-exempt press is a well-organized group that can be expected

to plan its litigation strategy circumspectly, we think it will prove difficult to develop a circuit conflict. We believe that the departure from even-handed administration of the tax laws required by the decision below is important enough — to the IRS, to Congress, and to respondent's taxpaying competitors in the marketplace — to warrant this Court's review.

For these reasons and for the reasons set forth in our petition, the petition for a writ of certiorari should be granted.

Respectfully submitted.

CHARLES FRIED
Acting Solicitor General

JUNE 1985